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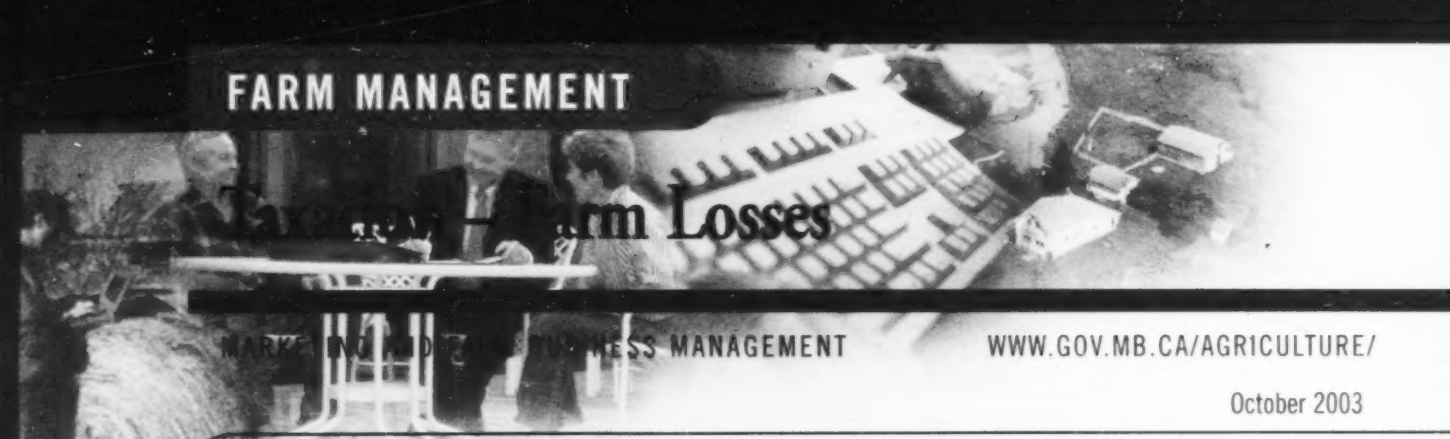

Taxation of Farm Losses

Introduction

This Information Update provides an overview of some of the tax issues and regulations that a part-time farmer will encounter. In comparison to a full-time farmer, there are some distinct differences in how taxable farm income is treated when there is another source of non-farm income. In particular, the major tax difference between the two is how farm losses are used to reduce the potential tax payable. The key to how these tax regulations are applied relies on *The Income Tax Act* and its classification of a part-time farmer.

Part-Time Farming Defined

There are three general classifications contained within *The Income Tax Act* as follows:

1. **Part-time Farmer** – *a taxpayer whose chief source of income is not farming, but who still carries on a farming business.* The taxpayer operates the farm with a reasonable expectation of profit, but devotes the major part of his or her time and effort to other business or employment. In the event of a deductible farming loss in a given year, this taxpayer will be restricted in the loss claimed.
2. **Full-time Farmer** – *a taxpayer whose chief source of income is a combination of farming and some other source of income.* The farming operation may be expected to provide the bulk of the income or the center of work routine and is the taxpayer's major preoccupation. In the event of a deductible farming loss in a given year, this taxpayer will be able to use the full amount of the loss to reduce other income.
3. **Hobby Farmer** – *a taxpayer whose chief source of income is not farming, but who carries on some farming activities, without a reasonable expectation of profit.* All farming losses are treated as personal or living expenses and cannot be deducted from other income in calculating taxable income.

These three definitions have provided the general guidelines in applying tax regulations. ***However,*** there have been several court cases over the years, that have further clarified who has been able to claim full farm losses. Further case arguments have been built around the following factors:

- To be a chief source of income, it is not necessary for farm income in a particular year to be greater than the other sources of income. Simply comparing net income from each source in a year is not a valid test for determining the chief source of income.
- Other prime factors: the time spent in the farming operation; the capital committed to the operation; the profitability of the operation (both actual and potential); and a clearly demonstrated intention to make farming a chief source of income.

These court cases suggest that losses be allowed as an unrestricted deduction where losses are being incurred in a **bona fide** effort to establish a viable farm enterprise.

Further definitions are also used to classify the part-time farmer and what comprises a farm business.

Farming Defined

The Income Tax Act gives a wide definition of "farming". It includes tillage of soil, livestock raising and exhibiting, maintaining of horses for racing, raising of poultry, fur farming, dairy farming, fruit growing, and beekeeping. In certain factual cases, the operation of a nursery or greenhouse, market gardening, fish farming, and operating a chick hatchery are also included in this definition. Court cases have included tree farming and the operation of a wild game reserve. However, farming does not include trapping or being employed by a farmer.

Farming Business Defined

The following criteria are considered in determining whether a farm operation is to be considered a business.

Taxation – Farm Losses

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Farming Business Defined

The following criteria are considered in determining whether a farm operation is to be considered a business.

a) **The extent of activity in relation to that of a business comparable in nature, size, and in the same locality.** The main test is the size of the property used for farming. If it is much too small to give any hope of profit, the presumption is that the property is being held for personal use or enjoyment of the taxpayer. Larger property holdings are also considered personal if the taxpayer has made no attempt at farming or to develop the land and lacks viable plans to do so. The farm may also be classed as personal, where the taxpayer has shown over several years no intention of using more than a portion of the land.
b) **Time spent on the farming operation in comparison to the time spent in employment or in other income earning activities.** If the taxpayer spends most of his or her time during the cropping season working on the farm, there is evidence of carrying out a farm business, particularly if the taxpayer also has a farm background and experience.
c) **The development of the farming operation and commitments for future expansion according to the taxpayers available resources.** This test is based on the capital investment in the operation over a number of years and on the acquisition of buildings, machinery, equipment and inventory by the taxpayer.
d) **Qualification of the taxpayer for some types of farming assistance.** Farming operations that report no, or very small amounts of gross income over several years are usually ruled to be non-business. It is recognized that this can occur in the first years of a farming operation or that it can be the result of prolonged and extremely adverse weather. However, where a taxpayer owns a piece of land that contains the home and grows a small quantity of fruit or maintains a few animals, the farming activities do not qualify as carrying on a business.

Restricted Farm Losses and the Part-Time Farmer

Those taxpayers that fall into the definition of a part-time farmer as described above, are allowed to deduct losses from other sources of income. However, **the extent of any loss deduction is restricted.**

The formula for deductions in this case is the lesser of:

a) the farming loss for the years; or
b) $2,500 plus one half of the next $12,500 to a maximum of $8,750.

The maximum loss deduction for a part-time farmer is, therefore, restricted to $8,750.

From a cash loss perspective, this means that any loss greater than $15,000 ($12,500 + $2,500 from (b) above) is capped at $8,750 for the purpose of your income tax return in that year.

However, a farm loss in excess of what can be deducted can be carried back and deducted from the preceding three years or carried forward and deducted from farm income of subsequent years. The carryforward amount is limited to the following ten years.

Example One:

A taxpayer that works as a receptionist also owns and operates a 40-cow beef herd. In 2002 the taxpayer chose to hold the calves as feeders which resulted in a farm net cash loss of $16,000. In 2003 the farm net income was $10,000.

2002		
Employment Income		$26,000
Farm loss; lesser of:	$16,000	
	$8,750	$8,750
Taxable Income		**$17,250**
Loss carryforward available for 2003		
$16,000 - $8,750 =		$7,250
2003		
Employment Income		$26,000
Farm Income	$10,000	
Less carryforward	$7,250	
	$2,750	$2,750
Income (before CPP and other deductions)		**$28,750**

When a restricted farm loss carryforward reaches the ten-year limitation it may be lost to the taxpayer. However, using the provisions of the *Optional Inventory Adjustment* can extend this benefit. See the Information **Update – "Farm Inventories"** for further information on this subject.

Calculating Farm Losses

Business Use of Home Expenses

Restrictions are placed on deductions for the expense of using part of your home as a place of business. The changes affect all forms of business including farming.

The first restriction is that no expenses are permitted unless a portion of the home is set aside and used solely for business. This rule will most likely be rigidly applied to farm homes located off the farm.

The second restriction affects all farmers in a year where a farm loss is reported. The amount you may otherwise deduct is limited to your income from the business before claiming any work space expenses in your home. If the farm lost money, you cannot increase the loss by claiming house

expenses. Any resulting unused portion of home expenses for business use can be carried forward and applied in future years as a cost against a positive farm income.

Subject to the rules described above, expenses that apply to the entire home such as: taxes; electricity; insurance; and mortgage interest should be allocated between business and personal use on a reasonable basis. A more precise allocation is to base it on square footage, or numbers of rooms. Expenses relating directly to the space used for business may be claimed in full.

The capital cost allowance of the home should also be allocated between business and personal use.

Mandatory Inventory Adjustment

In a year that a cash **loss** is incurred, the farmer is required to decrease the loss to the extent of the **purchased** inventory on hand at year-end. The required adjustment is called the **Mandatory Inventory Adjustment (MIA)**. It will be lesser of:

- the net farm loss calculated on a cash basis; or
- the value of purchased inventory on hand at year-end.

The MIA amount included as income in a year is deducted as an expense item in the following year.

This rule eliminates the past practice of some taxpayers deliberately creating a farming loss by the purchase of large amounts of inventory near year-end. Purchases of inventory can still be used to **reduce** farm profits, but not to create a loss.

Example Two:

2002

A taxpayer has a cash basis farm loss of $30,000. The taxpayer has $50,000 worth of inventory on hand at year-end, $16,000 of which was purchased.

Cash Basis Loss		($30,000)
Add MIA Lesser of:		
1. Loss of $30,000		
2. Purchased inventory of $16,000	$16,000	
Deductible farm loss		($14,000)

2003

The taxpayer now has a cash-basis income of $20,000. Year-end inventory on hand is $40,000, $5,000 of which was purchased.

Cash-Basis Income		$20,000
Deduct Prior Year MIA	$16,000	
Farm Income	**$4,000**	

Note that the $5000 purchased inventory is not used in the 2003 calculation, as the 2003 cash basis income does not show a loss as was experienced in 2002.

The MIA will have a significant impact on the deductibility of farm losses by farmers with large purchased inventories. For a detailed explanation of the rules and the procedure for valuing inventories consult the **Information Update – "Farm Inventories"** in this series.

Planning Considerations

Averaging

The Optional Inventory Adjustment provision is available to full- and part-time farmers as a method of averaging income. Further details can be found in the **Information Update – "Farm Inventories".**

Unused Restricted Farm Losses When Farm is Sold

Property taxes and interest (on borrowed funds used to acquire property) that was included in a previous restricted farm loss, may be added to the cost base of the land for purposes of determining capital gains.

Capital Gains

In general there is no distinction between part-time and bona fide farmers in the treatment of capital gains.

- The $500,000 farm capital gains deduction from the sale of farm land and buildings applies to part-time farmers. Special rules apply depending on the date of purchase.
- Part-time farmers can use the special $1,000 per year exemption for gains on a principal residence situated on the farm.
- Rollovers under *The Income Tax Act* will apply to the part-time farmer in the same way as they do to a bona fide farmer.

Consult the **Information Update – "Capital Gains and Losses"** in this series for more information.

Summary

Part-time farmers are subject to restricted farm loss amounts in deducting farm losses from other sources of income. Taxpayers with no prospect of making a profit from their farming activities may not deduct farming losses from other income.

Changes to the rules governing inventories and farmhouse expenses have significantly reduced the scope for claiming farm losses against other income in a particular year for both bona fide and part-time farmers.

Consulting with your accounting professional can also provide further details on the topics covered in this Information Update.

For Further Information Contact Your Local Manitoba Agriculture and Food Office.

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